Protecting Our Communities from Banking Mega-Mergers

Tom Schlesinger

The banking industry mega-mergers announced last July and August are unprecedented in size. Analysts say others will surely follow. Many of the same analysts reassure us that huge banking combinations and industry-wide consolidation are natural, inevitable, good for banking and good for the economy. The Bush Administration asserts that encouraging big banks to get bigger will level the financial industry's domestic playing field and enhance the global position of U.S. banks.

Rather than leveling the playing field, this bank-centered approach will only preserve its tilt. Underregulated firms, particularly giant financial companies, will continue playing a disruptive, lowest-common-denominator role at the fringe of the credit system. The bigger-is-better solution won't lay a glove on the underlying reasons the financial industry and lenders of all sizes flocked to ill-considered speculative investments over the past decade. The real culprits are regulatory inequality, weak supervision and decontrolled interest rates--not "too many banks."

There is little evidence that increased size will make U.S.-based banks more competitive in global markets--or that such a result might yield benefits in this country. For example, the proposed NationsBank merger will produce the largest bank in recent U.S. history to have virtually no international presence.

In addition to our skepticism about banking consolidation, the industry mega-mergers announced this summer raise three specific concerns: financial instability, economic dislocation, and concentration of economic power.

Financial Instability. These deals may well destabilize an already unstable industry, thereby increasing government's costs for bank failures, roiling financial markets and sapping public confidence. The performance of these mega-merger partners and the overall track record of large banks send ominous signals.

The primary causes of big-bank inefficiencies are not external factors or regulation. Several large banks have circumvented regulatory barriers to product and geographic expansion. The results often seem more impressive as legal stratagems than financial ventures. Given their experiences, many employees of big banks agree that their firms' inefficiencies result from the very internal conditions--such as excessive bureaucracy and rigidity, and perverse reward structures--that mega-mergers will magnify.

At worst, the current crop of mega-mergers may produce another First Republic- or Bank of New England-like meltdown. At best, these deals probably will produce sluggish institutions whose greatest area of synergy is nonperforming real estate loans and whose principal activity will be limping into line at the discount window.

According to a recent analysis in *Barron's*, five of the six banks involved in pending mega-mergers--Chemical, North Carolina National Bank (NCNB), C&S/Sovran, BankAmerica and Security Pacific--rank among the nine banks with the greatest commercial real estate exposure.[1] On average, commercial real estate loans equaled 120 percent of these five banks' year-end 1990 net worth. From first quarter 1990 to first quarter 1991, foreclosed property rose at an average rate of 113 percent for the five mega-merger partners. Foreclosed and problem loans averaged 41.1 percent of the five banks' net worth as of March 31.

Bad real estate lending isn't the only vice these banks share. They also followed the trend to risky leveraged buy-out (LBO) loans. At the end of 1990, all six of the

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mega-merger partners ranked among the top 20 banks in highly leveraged transactions (HLT) lending, with a combined $16.9 billion in HLT outstanding. That sum represents 28 percent of all HLT exposure for the 25 lenders who account for most of the banking industry's highly leveraged financing.[2]

These numbers say that bigger equals weaker, not better. Even more important, they suggest that big banks seeking to grow out of their problems have systematically misinvested depositors' money in unproductive ventures that add little to the nation's economic well-being. Why should we expect them to manage even larger portfolios with keener regard for the bottom line or America's economic health?

In an indirect sense, mega-mergers are destabilizing because they offer phony substitutes for the difficult, thoughtful changes that might actually reverse banking's fatal spiral. The longer we defer real reform of deposit insurance, regulatory inequalities and other structural problems, the deeper the industry will dig its own hole.

Economic Dislocation. Mega-mergers will generate a number of problems in the real economy above and beyond the effects of additional bailouts on public confidence, consumer buying power and the availability of public resources. Widespread unemployment, concentrated in cities that staked their development on financial industry growth, will be the most obvious consequence of mega-mergers. According to published reports, the Chemical-Manufacturers Hanover Trust (MHT) merger may result in at least 6,000 layoffs,[3] the Nationsbank merger in 9,000 layoffs[4] and the BankAmerica-Security Pacific merger in 20,000 layoffs.[5]

These layoffs have been heralded as a sign of belt-tightening efficiency. Yet they will disproportionately hit lower-paid workers, like the employees at NCNB Florida whose average salary and benefits declined from $17,940 in 1989 to $17,768 in 1990, according to Sheshunoff Information Services.[6] The real fat in bank overhead--CEO salaries, directors' perks and the like--will never be subjected to the indignity of a cholesterol test (see Table 1).

By reducing competition, mega-mergers will narrow the choices available to household and business users of banking services and raise their costs. Recent studies of commercial lending data by Federal Reserve economists confirm the connection between banking concentration and higher prices for bank consumers. In addition, mega-mergers probably will squeeze the supply of credit and other banking services to already underserved areas of the economy.

Concentration of Wealth. These mergers will result in excessive concentrations of economic power. They threaten to put a government seal of approval on the idea that fewer, rather than more, people should own and control our most basic economic resources. This past September, the Southern Finance Project released a study indicating that 1991's mega-mergers will have profoundly adverse effects on competition in local banking markets, particularly those in affected areas of the West and the

TABLE 1: COMPENSATION AND PERFORMANCE COMPARISONS FOR MAJOR MERGING BANKS

INSTITUTION CEO	CEO 1990	CEO 1989	AVERAGE EMPLOYMENT 1990	AVERAGE EMPLOYMENT 1989	CHANGE IN STOCK PRICE
Chemical NY			53,291	50,356	-64.0%
Walter Shipley	$738,167	$1,118,430			
Chemical NJ			33,713	32,160	
Texas Commerce-Houston			36,966	35,803	
Texas Commerce-Dallas			32,205	28,404	
Manufacturers Hanover			49,662	46,395	-36.2%
John McGillicuddy	$1,082,000	$1,680,323			
NCNB TX			26,528	28,524	-50.5%
Hugh McColl	$752,515	$1,200,000			
NCNB NC			31,343	31,018	
NCNB FL			17,768	17,940	
NCNB SC			20,880	20,286	
C&S/Sovran VA			31,199	30,086	n.a.
Bennett Brown	$880,273	$978,081			
C&S/Sovran GA			29,421	28,117	
C&S/Sovran FL			26,425	25,594	
C&S/Sovran TN			29,114	21,288	
C&S/Sovran MD			32,874	31,394	
C&S/Sovran SC			22,427	21,389	
BankAmerica CA			38,189	36,898	-0.9%
Richard Rosenberg	$1,600,000	$1,250,000			
Seafirst			34,054	32,265	
Security Pacific CA			37,490	36,151	-49.2%
Robert Smith	$789,600	$1,027,900			
Security Pacific WA			34,926	33,645	
Security Pacific AZ			40,352	38,507	
Security Pacific OR			34,887	32,193	

CEO 1990/1989: Total compensation includes salary, bonus, deferred compensation and other forms of cash-equivalent compensation.
AVERAGE EMPLOYMENT 1990/1989: Average salary and benefits per employee at affiliate banks.
CHANGE IN STOCK PRICE: Percent change in stock price from year-end 1989 to year-end 1990.

SOURCES: SNL Executive Compensation Review: 1991; Sheshunoff 1000 Largest U.S. Banks, 1991 and 1990.

Southeast.[7] The study shows:

- According to U.S. Justice Department guidelines, the BankAmerica and Nationsbank deals would produce "highly concentrated" conditions in 81 of the 99 counties in Arizona, California, South Carolina and Washington where the merger partners currently operate competing offices.
- In a quarter of those counties, post-merger concentration levels would rise to more than double the statistical threshold that signals adverse effects on competition and triggers antitrust action.
- Despite a record of generally lax antitrust enforcement during the 1980s, the Justice Department challenged a number of banking mergers over local concentration levels far lower than those threatened by 1991's mega-mergers. In 42 of the 99 affected counties in Arizona, California, South Carolina and Washington, post-merger concentration levels would surpass the levels that generated a recent federal antitrust challenge to Fleet/Norstar's FDIC-assisted takeover of Maine National Bank.
- Bargain-basement government sales of failed banks and thrifts to NCNB, BankAmerica and Security Pacific will compound the anticompetitive effects of 1991's mega-mergers. The report terms the BofA-SecPac deal "the world's largest RTC trophy case," since the bailout agency has furnished the two banks with $24.6 billion in banking resources --74 percent of all deposits sold by Resolution Trust Company (RTC) in Western states. The extremely favorable terms of those deals put BofA-SecPac's rivals at a double disadvantage.
- After a merger, NCNB and Bank of America would dominate non-local banking markets for medium-sized business borrowers in South Carolina and parts

A Proposal for Public Purpose Banking

This outline for public purpose banks should be considered as a broad concept, recognizing that many details remain to be debated and refined by citizens, policy makers and public-spirited lenders whose experiences provide models for such a system. The purpose for such a system is to restore the widespread ownership of financial intermediaries while investing in a broad spectrum of resources needed to enhance the national economic performance and revitalize communities. A public purpose banking system should be built incrementally by expanding the existing. but tiny, infrastructure, of public-spirited lenders through a) the application of tough antitrust standards to banking industry consolidation; and b) the resolution of bank and thrift failures.

Ownership

Public purpose banks will be mutually owned by their depositors. The principal means for defining the banks' ownership group will be the communities they are chartered to serve. By complying with public purpose standards for governance, lending and supervision, other traditional and non-traditional lenders (community development loan funds and credit unions, stockholder-owned development banks and commercial banks, hybrid intermediaries, etc.) also could operate as public purpose banks.

Governance

Public purpose banks should be democratically governed by their owners, who would be responsible for selecting a majority of each institution's directors. Accountability mechanisms linking management, directors and owners could include: regular, detailed disclosure of financial information; annual independent audits; votes by owners on major policy initiatives by the banks; and free access by owners to the vote.

In order to prevent effective control of the institution passing to a small number of affluent or powerful members (as has happened at Farm Credit System Production Credit Associations (PCAs) and many mutually-owned depositories), the board should maintain aggressive member education and involvement programs.

Capitalization

In order to gain the solid equity base needed for effective intermediation, public purpose banks should be able to obtain capital through the following means:

- Equity contributions from the Tier 1 capital of megamerging Bank Holding Companies (BHCs) that are proportionate to the divested branches' percentage of the merging institutions' total resources;
- Voluntary investments by state governments, local governments and pension funds in a special class of restricted-voting shares;
- A portion of receipts from asset appreciation fees levied on investors who resell RTC and FDIC properties within five years of purchasing them. One precedent for this fee is the net recapture agreement provision of the 1987 Agricultural Credit Act, which exposes Farm Home Administration borrowers to an appreciation tax on farm assets.
- Tax-advantaged investments by individuals in a limited class of voting shares.

Sources of Funds

Public purpose banks should be able to access funds through the following mechanisms:

Favorable access to the deposits of

of the West Coast. Such firms already rely on an narrow universe of competitors for their primary banking relationships.

These research findings raise a number of practical questions for state and federal antitrust enforcers. They also raise broader questions about who will control the nation's most vital economic functions--money creation, the payments system and financial intermediation. The Supreme Court's landmark *Philadelphia National Bank* decision addressed those broad questions with blunt eloquence. In 1963, the Court wrote:

> The fact that banking is a highly regulated industry critical to the Nation's welfare makes the play of competition not less important but more so. If the businessman is denied credit because his banking alternatives have been eliminated by mergers, the whole edifice of an entrepreneurial system is threatened; if the costs of banking services and credit are allowed to become excessive by the absence of competitive pressures, virtually all costs in our credit economy will be affected; and unless competition is allowed to fulfill its role as an economic regulator in the banking industry, the result may well be even more government regulation. It is surely the case that competition is our fundamental national economic policy, offering as it does the only alternative to the cartelization or governmental regimentation of large portions of the economy.

Recommendations for Change

Government should take the folowing steps to respond to banking mega-mergers and the problems of concentration, economic dislocation and financial instability associated with them.

1. The standards used by federal financial regulators

megamerging and failed institutions. Specifically, receiving the deposits of branches divested by mega-merger partners in order to comply with antitrust standards; receiving, on a first option basis, deposits of insolvent institutions resolved by RTC and FDIC in insured deposit transfers. Public purpose banks also should receive preferential access to deposit franchises resolved by RTC and FDIC in purchase and assumption deals.

Discounted deposit insurance premiums. Public purpose banks should pay premiums at 80 percent of the lowest prevailing assessment rate for other insured depositories. For example, if the lowest assessment paid by banks, thrifts and credit unions to the FDIC and NCUSIF were 20 basis points, public purpose banks would be assessed 16 basis points.

The discount would give public purpose banks a structural advantage similar to the low-cost funding that an earlier type of specialized lender (S&Ls) received via interest rate controls. Since we believe it is necessary to reform the current deposit insurance assessment, preference for public purpose banks ultimately should be replaced by rate mechanisms built into a system of flexibility recontrolled rates.

Public Deposits. A federal requirement that public bodies (e.g., local governments, school boards, port authorities, etc.) and Pension Benefit Guarantee Corporation-backed pension funds place a designated small percentage of their total transaction deposits and a designated small percentage of their total non-transaction accounts with local public purpose banks.

Lending Mandate

Portfolio requirements for public purpose banks should be characterized by flexibility and diversification. They must reflect community economic needs and national priorities.

- Investments in housing, community and industrial development, health and child care, agriculture and environmental protection should constitute no less than 80 percent of the banks' loans (Qualified Public Lender test).
- Public purpose banks should maintain an annual loan-to-asset ratio that exceeds by some fixed percentage the loan-to-asset ratio (averaged over three years) for Bank Insurance Fund-insured institutions with less than one billion dollars in assets.
- Loans should be made within 100 miles of the bank's headquarters in MSA counties and within a reasonable (perhaps multi-county) service area surrounding the bank's headquarters in non-MSA counties. Some exemptions may be made on a case-by-case basis for syndicating or participating in non-local ventures of special public interest.
- A reasonable portion of bank loans (the exact portion to be determined annually by the chartering agency) should involve the banks in state and federal credit programs consistent with their overall lending mission (e.g., Small Business Administration, FmHA, etc.).
- Loans to a single borrower should be restricted. Off-balance-sheet activities and loans to officers, directors, and their related parties should be prohibited or severely restricted.
- Banks should have access to a public purpose secondary market established through their chartering agency.
- Banks should provide their borrowers debt mediation and restructuring services financed by retained earnings and a "check off" system.

to evaluate proposed bank mergers--especially large mergers that exceed a specified size threshold--should be clarified, codified and made public. The vague, shifting, subjective and unwritten guidelines currently used for merger reviews should be replaced by explicit written standards that:

- Spell out the types of product and geographic markets to be analyzed;
- Quantify the benchmarks by which competitive effects are evaluated;
- Fully factor in any existing competitive advantages that the government has conferred on the applicants;
- Eliminate the "convenience and needs" defense of banking mergers due to its slippery meaning and history of usage.
- Consider the effects of mergers on customers such as middle-market businesses that use non-local banking markets and are crucial to the health of local economies.

These measures would reduce the discretion and enhance the public disclosure of regulatory activity. Like complementary proposals for "early intervention" in failing banks and restricting use of the Fed's discount window, such initiatives would make financial regulation more transparent, more consistent and more clearly in the public interest.

2. Restrictions should be placed on the portion of total deposits and IPC deposits that can be controlled by any single institution on a state, county and Metropolitan Statistical Area basis. If necessary, the federal benchmark should preempt more liberal state standards.

3. Banking regulators should direct government and non-governmental organizations in affected areas to conduct comprehensive social and economic impact studies prior to approving bank mergers involving institutions whose parent companies hold combined assets exceeding $50 billion. If these studies predict substantial social or economic dislocation, regulatory approval should be conditioned on the implementation of a comprehensive mitigation program, funded by a merger tax on the merging institutions.

The principal components of merger-mitigation programs should include (but not be limited to) the following elements:

- Strict compliance with the Worker Adjustment and

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Such services should be available to distressed borrowers whose income falls within a reasonable standard (e.g., 120 percent) of local median income and whose loan is part of the bank's Qualified Public Lender portfolio.

Regulation and Supervision

A federal agency, the Office of Public Banks, should be created to charter and promote the expansion of public purpose banks. Like the Federal Reserve and the FHLB systems, the Office should maintain reserves for and provide backup liquidity to public purpose banks. The Office could be established on a national, regional or state basis. The Office should have no regulatory or insurance functions.

A completely separate (existing or new) federal agency should serve as primary regulator and insurer of public purpose banks, performing examination and supervision functions. Only a federal charter should be available for public purpose banks; however, existing state- or federally-charted institutions should be allowed to convert to a public purpose charter if they meet the appropriate ownership, governance, capitalization, portfolio and management tests.

In addition to meeting the reserve requirements of the Office of Public Banks, public purpose institutions should meet soundness standards comparable to those demanded of other insured financial institutions. However, the primary regulator should determine and enforce separate risk-weighted capital and reserve standards for public purpose banks. Supervision also should take into account the case of public purpose banks that choose to operate on a not-for-profit basis. Public purpose banks should operate with a state and federal tax exemption. Failure to comply with lending standards should result in the loss of the exemption.

Management

Public purpose banks should present a qualified management team and sound management plan in order to receive a charter from the Office of Public Banks. To help stimulate and sustain the infusion of managerial and technical skills needed for public purpose banking success:

- The Office of Public Banks should maintain an active technical assistance division, dedicated to the support and continuing education of start-up management teams. The division should be funded by mega-merger taxes and a fee on clearinghouse transactions.
- Matching state-federal EDWAA funds should be used to train and place in public purpose banking jobs a corps of employees who have been laid off as a result of banking mega-mergers. The "Lender Corps" notion also could be expanded to include the recruitment and placement of retired and other unemployed persons with banking and/or management skills.

Retraining Notification (WARN) Act's 60-day notice provision.

- A mandatory 60-day consultation period, triggered by the WARN notice, in which representatives of employees, management and government negotiate alternatives to a closing or layoff.
- Establishment of adjustment committees based on the Canadian model to oversee retraining, education and relocation programs for laid-off bank employees. The Economic Dislocation and Worker Adjustment Assistance Act (EDWAA) provides resources for these joint labor-management committees to be staffed by an independent third party. The committees are authorized to survey dislocated workers for outplacement; screen, hire and fire adjustment service providers; and monitor the re-employment process. For instance, the United Food and Commercial Workers have proposed a model assistance center for dislocated Security Pacific and Seafirst employees.
- Use of EDWAA funds for alternative ownership pre-feasibility studies that draw up detailed management plans for converting divested branches into public purpose banks.
- A "Lender Corps" program, subsidized by EDWAA discretionary funds and a merger tax, that retrains and places laid-off bank employees in staff positions at these public purpose banks. These employees would help fill the managerial and technical gaps that nag existing community lenders.

4. Branches divested by mega-merger partners in order to comply with antitrust standards should be converted to mutually-owned "public purpose banks" with a lending mission that serve community needs and national economic priorities. Branches and franchises in RTC and FDIC conservatorship also should be eligible for conversion to public purpose banks (see sidebar).

Such banks could be given or sold on a preferential basis to existing development banks, community development credit unions, community development loan funds or similar intermediaries. Another possibility is that these banks be chartered separately on the credit union model, with the community defined as the affinity group. State and local government units could also invest in such banks as could pension funds. Portfolio requirements would reflect broad national investment needs as well as diversification and other prudent standards.

The principle behind public purpose banking is simple. If the government is going to promote or condone a dramatic concentration in ownership and control of banking resources, it should simultaneously support a second tier of financial institutions better attuned to the nation's credit needs and the American tradition of widespread economic ownership.

The two-tiered approach is a long-standing reality in some countries, including nations whose ostensibly centralized banking systems are relentlessly cited as the wave of the future by bank consolidation advocates in the U.S. For example, the German banking system is best known for its handful of mammoth universal banks. But the country also hosts, and promotes through public policy, a flourishing tier of smaller financial intermediaries that includes thousands of cooperative banks, savings banks, mortgage banks and postal savings offices. Even though these smaller institutions have undergone a merger boom in recent years, Germany still has more banking institutions per capita than the U.S. has banks and thrifts.

5. All financial firms should be subject to uniform licensing and regulation and should meet a modicum of public obligations in return for their license. The S&L experience demonstrates the foolishness of leveling the playing field by lowering it to a less-regulated common denominator. In order to stabilize the financial system and achieve real regulatory equality, comparable soundness requirements (capital and reserve standards, disclosure, etc.) and prohibitions against conflict of interest and unfair competition should be applied to any entity that: directly accepts funds from the public for investment; makes loans to the public using funds other than its own equity capital and retained earnings; or sells loans to financial institutions or investors.

Regulatory equality is not an answer to mega-mergers *per se*. Rather, it represents an alternative to the banking industry's broad program of consolidation and decontrol. It may or may not imply "more" regulation; it would certainly provide smarter regulation. As the body count mounts in the financial industry, the nation needs to debate and implement real reform, rather than permitting mega-mergers to delay the banking system's day of reckoning and make that day vastly more expensive to taxpayers.

Notes

[1] Maggie Mahar, "The Great Collapse: Commercial Real Estate is on the Skids across the Nation", *Barron's*, July 22, 1991.

[2] American Banker, *Ranking the Banks* 1991.

[3] *Wall Street Journal*, pg. 1, July 16, 1991.

[4] Robert Trigaux, "Are Bigger Banks Better Banks?" *Public Citizen*, Sept/Oct 1991.

[5] *Los Angeles Times*, pg. 1, Business Section, August 13, 1991.

[6] SNL Executive Compensation Review: 1991; Sheshunoff 1000 Largest U.S. Banks, 1991 and 1990.

[7] Southern Finance Project, "The Bigger They Come," September 1991.